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Supreme Court, U. S.
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IN THE

SUPREME COURT OF THE UNITED STATES

October Term, 1971

No. _____

GEOGHEGAN & MATHIS, INC. - - Petitioner

versus

COMMISSIONER OF INTERNAL REVENUE - - - - - - - Respondent

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT

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No. _____

GEOGHEGAN & MATHIS, INC. - - - - *Petitioner*

v.

COMMISSIONER OF INTERNAL REVENUE - *Respondent*

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT

Petitioner, Geoghegan & Mathis, Inc., prays that a writ of certiorari be issued to review the judgment of the United States Court of Appeals for the Sixth Circuit (its Case Number 71-1439) entered in the above case on January 28, 1972.

OPINIONS BELOW

The opinion of the United States Tax Court is reported at 55 T.C. 672 (1971). The opinion of the Court of Appeals for the Sixth Circuit is reported at 453 F. 2d 1324. A copy of the opinion of the Tax Court appears in the appendix, *infra,* at pages 19-26, and a copy of the opinion of the Court of Appeals for the Sixth Circuit appears in the appendix at pages 27-33.

JURISDICTION

The judgment of the Court of Appeals for the Sixth Circuit was made and entered on January 28, 1972. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

QUESTIONS PRESENTED

Petitioner, an open pit quarry operator, paid a utility company for the cost of relocating that portion of a gas pipeline which transversed petitioner's mineral tract and impeded the advancement of the quarry mining face. The original location of the pipeline was within an easement granted to the utility company by petitioner's predecessor-in-title. Removal of the pipeline was accompanied by a grant by petitioner to the utility company of a new easement around the perimeter of its property for the relocated pipeline and a simultaneous release to petitioner of the original easement across its tract. In computing its Federal income tax petitioner deducted from its gross income the cost of the pipeline relocation as a mine development expense under Section 616(a) of the Internal Revenue Code of 1954. Alternatively, it claimed the payment deductible as an ordinary and necessary business expense under Code Section 162(a), as supplemented by the "receding face" doctrine applicable to mining expenditures.

The respondent disallowed the deduction, asserting that the expenditure was part of the capital cost of land.

The Tax Court upheld the respondent and it was affirmed by the Court of Appeals.

The questions presented are:

1. May a mining operator deduct as an "expenditure for the development of a mine or other natural deposit" under Section 616(a) of the Internal Revenue Code of 1954 the cost of removing an artificial obstruction to its ongoing mining process, where the expenditure is made to gain access to minerals which it already owned, and when the removal of the obstruction is accompanied by the release of an easement dominant to the mining tract?

2. Under such circumstances, and where removal of the obstruction is necessitated solely by reason of the prior recession of the mining face as a result of the mining process, may the expenditure be deducted as an ordinary and necessary business expense of mining?

These questions are of particular significance to the mining industry. But a question of much broader significance to the administration of the tax law, not expressly met in the opinions of the courts below, is also presented:

3. Where a payment is entirely made for and appropriated to an object or function which, when considered alone, would render the payment wholly deductible for Federal income tax purposes, is the payment rendered non-deductible solely by reason of the concomitant receipt by the taxpayer of a capital benefit, encompassed within the total transaction, to which separate contractual consideration is allocable?

STATUTES AND REGULATIONS INVOLVED

The principal statutes involved are Section 616(a) and Section 162(a) of the Internal Revenue Code of 1954. Section 616(a) provides as follows:

> "(In General)—Except as provided in subsection (b), there shall be allowed as a deduction in computing taxable income all expenditures paid or incurred during the taxable year for the development of a mine or other natural deposit (other than an oil or gas well) if paid or incurred after the existence of ores or minerals in commercially marketable quantities has been disclosed. This section shall not apply to expenditures for the acquisition or improvement of property of a character which is subject to the allowance for depreciation provided in section 167, but allowances for depreciation shall be considered, for purposes of this section, as expenditures."

The full text of Section 616 is set forth in the appendix, *infra,* at page 34.

Section 162(a) provides in pertinent part as follows:

> "(In General)—There shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, * * *"

Also involved are Treasury Regulations, Sections 1.616-1 (1960) and 1.612-2 (1960), both of which are reprinted in the appendix, respectively, at pages 35-37 and 37-38.

STATEMENT

All of the facts and exhibits were stipulated to the Tax Court.

The business of the petitioner is the operation of limestone quarries. In 1959, petitioner purchased the fee simple title to a tract of land near Bardstown, Kentucky. Prior to petitioner's purchase, it had been determined that the tract contained limestone in commercially marketable quantities and that such limestone lay under the entire surface of the tract.

An eight inch gas pipeline diagonally crossed the central portion of the tract approximately thirty inches below the surface. The owner of the pipeline, Louisville Gas & Electric Company, possessed a perpetual easement, granted in 1944 by petitioner's predecessors-in-title, for the purpose of constructing and maintaining the pipeline. The easement carried with it no mineral rights, and reserved to the fee owner full use of the premises within the right-of-way boundaries, except for the purposes granted to the utility.

In 1959, the petitioner began extracting limestone on the western boundary of the tract, using the open pit or open face method of mining. The operation progressed from the west side of the property toward the east and northeast sides. Operations were not initially affected by the pipeline, but by late 1963 the mining face had been brought near the pipeline, and it became apparent that the existing mining face could no longer be advanced unless the pipeline was relocated.

Petitioner entered into negotiations with the utility company to accomplish the pipeline's relocation and an agreement was reached whereby petitioner agreed to bear the actual cost of physically removing and rerouting the pipeline around the eastern and northern boundaries of its tract. Separately, but as a part of the overall arrangement, a "Grant and Release of Easement" was executed on January 16, 1964 by petitioner and the utility company which granted to the utility company a new easement for the location of its pipeline, and simultaneously released to petitioner the existing right-of-way through the center of its tract. The relocation work was performed during 1964, and on December 4, 1964 the utility company invoiced petitioner for the cost of the work in the amount of $14,682.78, which petitioner paid on December 28, 1964. After relocation of the pipeline, petitioner extended the mine face through normal operations to the eastern portion of the tract.

In its Federal income tax return for its taxable year ended February 28, 1965, petitioner claimed a deduction for the payment of $14,682.78 as a development expense under Section 616(a) of the Internal Revenue Code of 1954. The deduction was disallowed by the respondent on the ground that the expenditure represented the cost of acquisition of land.

The respondent's determination was timely appealed to the United States Tax Court, whose jurisdiction was based on Internal Revenue Code Sections 6214 and 7442.

Upon fully stipulated facts and exhibits, the Tax Court concluded that the payment by petitioner was inseparable for tax purposes from the release of the easement, notwithstanding the fact that the entire payment was solely for the cost of the physical relocation of the pipeline. The Tax Court considered the payment to be for a right of access to petitioner's limestone deposits—a right which the Tax Court regarded as equivalent to an interest in land, and hence not deductible either as a mine development expense or as an ordinary and necessary business expense (55 T.C. at p. ——; appx. at p. 25).

The Court of Appeals affirmed, finding that —

> "[T]he right of access to the minerals was impaired by the right of the utility company to maintain its pipeline through the center of the tract. The purchase of this right and the concomitant relocation of the pipeline by the appellant was an essential element in the acquisition of the right of access to the minerals, and therefore must be treated as part of the cost of the mineral rights themselves." 453 F. 2d 1324, 1327-1328, appx., p. 32.

REASONS FOR GRANTING THE WRIT

I. The Court of Appeals for the Sixth Circuit has rendered a decision important to the administration of the Internal Revenue Code which is in direct conflict with the decision of the United States Court of Claims in *Kennecott Copper Corporation* v. *United States*, 347 F. 2d 275 (Ct. Cl. 1965), *nonacq.*, Rev. Rul. 67-35, 1967-1 Cum. Bul. 159.

By reason of the conclusions of the courts below that the claimed deductible payment was inseparable from the release of the easement, notwithstanding that no part of such payment was assigned by the parties to such purpose, the decision below was acknowledged by both the Tax Court (55 T.C. at p. 676; appx., p. 24) and the Court of Appeals (453 F. 2d at p. 1328; appx., p. 31) to be in conflict with the *Kennecott Copper Corporation* decision. In the *Kennecott Copper Corporation* case, the Court of Claims held that where the primary purpose and the result of an expenditure were to gain physical access by extension of a producing mine to minerals owned by the taxpayer, the expenditure was a deductible development expense, notwithstanding the fact that the means of such access, acquired by the claimed expenditure, were rights with common law real property characteristics.

The facts in *Kennecott* may be condensed as follows:

Kennecott owned and operated an open pit copper mine. The mouth of the excavation had been extended by previous operations until it was close to property owned by a neighbor, United States Smelting, Refining and Mining Co. (USSRMCO). Kennecott thereupon acquired stripping, dumping and transport rights as to USSRMCO's tracts in order to continue expansion of the mouth of its excavation and thus gain access to the copper deposits upon its own property. The sole consideration moving from Kennecott to USSRMCO in exchange for the access rights was an undertaking to provide substitute facilities (physical

structures) for those of USSMRCO that would be destroyed in the process. The cost to Kennecott of such facilities, supplied during the seven-year period 1949-1955, was $14,500,000.00, which Kennecott amortized and deducted over the nine-year period of 1949-1957 against income from its copper deposits which were benefited by the rights Kennecott had acquired.

The Court of Claims first found that the expenditures were not currently deductible as "receding face" expenditures under the tests set forth by the then applicable Treasury Regulation,[1] because acquisition of the surface rights was not necessitated "solely because of the recession of the working faces of the mine." 347 F. 2d at pp. 296-297.

The court then considered whether the expenditures were otherwise deductible as ordinary and necessary business expenses to be deducted ratably as deferred expenses, or, with respect to years after 1950, deductible currently as "development expenditures" under Section 23(cc) of the Internal Revenue Code of 1939. It concluded that the deduction depended upon whether the expenditures constituted "development costs."

In an exhaustive opinion, the Court of Claims undertook to ascertain the meaning of the term "development costs" in a context which would distinguish such costs from capital outlays subject to depletion.

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[1]Regulations 111, Section 29.23(m)—15(a) and (b), relating to the Internal Revenue Code of 1939. The "receding face" doctrine is reflected in the current Treasury Regulations, Sec. 1.612-2.

It took notice of the difficulty of this task:

> "The phrase 'development costs' entered the language of the tax law as descriptive of costs incurred in bringing a mine into production. Now, there is recognition of development costs incurred after the mine has reached the producing stage. Preparatory development costs have been fairly well defined. The development costs of a producing mine have not been so well defined. * * *
>
> "[T]he cases which bear on the issues here presented involve many borderline conclusions in their appraisal of particular situations. Instances are not uncommon of oversimplification, of classification by fiat, or of a gloss of added emphasis to compensate for uncertainty. The result is that attempts to harmonize the decisions often prove futile." 347 F. 2d at p. 282.

The court concluded that the crucial characterization it had to make was between the cost of *access* to minerals already owned and the cost of acquisition of such minerals. It held that the surface rights which Kennecott paid for, tested by this criterion, were deductible development costs.

The Court of Appeals in the instant case held that the Court of Claims had placed undue emphasis on the concept of *access* in defining the term "development expenditure." It found the "commonly accepted" definition of "development expense" to be "that *activity* necessary to make a deposit accessible for mining" (emphasis supplied), relying upon legislative history and *Santa Fe Pacific Railroad Company* v. *United States*, 378 F. 2d 72, 76 (7th Cir. 1967) and

Amherst Coal Company v. *United States,* 295 F. Supp. 421, 441 (S.D. W. Va. 1969) aff'd *per curiam,* Fourth Circuit Nos. 14,257-14,260, Filed 1-19-71; 27 AFTR 2d 71-460, 71-1 USTC par. 9223. Since the Court did not regard petitioner's expenditure as one for *"activity,"* it concluded there could be no deduction.

Undoubtedly, "activity" has been involved in most of the cases dealing with mine development costs, but it is by no means settled that activity is the exclusive prerequisite for deductibility. The legislative history[2] which the Court of Appeals found consistent with its definition does not contain a definition of development expenditures. The change in the law with which the various committee reports were concerned dealt principally, not with the essential nature of development expenditures, but rather with the time they were to become deductible as measured in terms of the stage of life of the mine.

Neither *Santa Fe Pacific Railroad Co.* nor *Amherst Coal Co.* cited meaningful authority for the proposition that the "activity" definition was "commonly accepted". Moreover, in *Estate of Alexia D.O. DeBie*

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[2]Committee reports accompanying Section 23(cc) of the Internal Revenue Code of 1939, added by Section 309(a), Revenue Act of 1951, 65 Stat. 452, 486-487, which was the predecessor section of I.R.C. Section 616(a). The Court of Appeals cited H. Rept. No. 586 (Ways and Means Committee), 82nd Cong., 1st Sess., pp. 30-31, 107-108, 1951-2 C.B. 357, 379-380, 434-435; S. Rept. No. 781, Part 1 (Finance Committee), 82nd Cong. 1st Sess., pp. 43-45, 1951-2 C.B. 458, 489-490; S. Rept. No. 781, Part 2 (Finance Committee Supp. Rept.), 82nd Cong., 1st Sess., pp. 21-22, 1951-2 C.B. 545, 558-560; H. Rept. No. 1213 (Conference Committee), 82nd Cong., 1st Sess., p. 71, 1951-2 C.B. 622, 625-626; Report of Staff of Joint Committee on Internal Revenue Taxation (October, 1951), pp. 25-26, 1951-2 C.B. 287, 306-307.

56 T.C. 876, the Tax Court surmised (footnote 4) that there was considerable doubt within the mining industry itself as to the precise meaning of the terms "development" and "exploration" as applied to mine expenditures.

The issue here presented is likely to be one of recurring significance. With a fixed amount of land and an increasing national demand for minerals of all kinds, mining operators who must extend existing mines will with increasing frequency find it necessary to negotiate with and compensate possessors of conflicting easements, licenses and other less-than-fee, nonmineral interests. For example, see Rev. Rul. 66-170, 1966-1 Cum. Bul. 159, where a fact situation similar to the instant case is posed.

II. Petitioner in the courts below alternatively asserted that its expenditure was deductible as an ordinary and necessary business expense under I.R.C. Section 162, as supplemented by the "receding face" doctrine applicable to mines. The "receding face" doctrine is recognized by Treasury Regulations, Section 1.612-2 (1960) (appx., p. 24) which, however, limits deductibility under the doctrine to expenditures for qualifying *equipment*. The remaining requirements of the regulations are (a) that the expenditures, made "solely because of the recession of the working faces of the mine," must be necessary to maintain (as distinguished from attain) normal output; and (b) that the expenditures do not increase the value of the mine, or the cost of production of mineral units, or

"represent an amount expended in restoring property or in making good the exhaustion thereof for which an allowance is or has been made. * * *"

The rationale of the doctrine was enunciated in *Marsh Fork Coal Co.* v. *Lucas,* 42 F. 2d 83 (4th Cir., 1930):

> "We think it is but fair to charge against the coal which has been mined the expense which its removal has necessitated. * * * To capitalize the expenditure made to *maintain normal output* means that the cost of removal is pyramided against the coal further back in the mine, with the result that the coal nearest the headhouse will appear to have been mined at an abnormal profit and that farther back at a loss." 42 F. 2d at p. 85. (Emphasis supplied.)

Petitioner's expenditure, obviously made to maintain normal output, would qualify under the criteria of the regulation cited except that it concededly was not for the acquisition of equipment. While most of the cases involved the receding face doctrine have been concerned with expenditures for equipment,[3] there appears to be no sound reason for limiting the doctrine to equipment expense, absent any statutory restriction. In this case the Tax Court and the Court of Appeals, having concluded that petitioner's expenditure represented the cost of real property, found it unnecessary to further consider petitioner's alternative assertion of the receding face doctrine. If certiorari is granted,

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[3]Many examples of qualifying expenses are set forth in *U. S. Gypsum Company* v. *U. S.*, 206 F. Supp. 744, at 750 (D.C.N.D. Ill., 1962).

we will ask this Court to consider applicability of the receding face doctrine if for any reason it finds that the claimed expenditure, though not representing the cost of a real property interest, is nevertheless unqualified as a deduction for development expense under Section 616. In this event, the Court may settle the issue as to whether the "receding face doctrine" is restricted to expenditures for equipment.

III. If the petitioner's expenditure, made solely for the removal and relocation of the pipe line, had been considered separately for Federal income tax purposes from the grant and release of easements entered into by petitioner with the utility company, then its expenditure unquestionably would have been held to have been one for "activity necessary to make a deposit accessible for mining" (the definition of "development" preferred by the Court of Appeals) and there would have been no conflict with the *Kennecott Copper Corp.* decision. The fully stipulated facts (record, Stipulation of Facts, pars. 10, 11) and exhibits (Exhibits 6, 7, and 8) make it clear that no portion of the pecuniary payment was allocated or attributable to the release of the easement, and indeed was determined precisely and only by the cost, established after the work was accomplished, of relocating the pipeline.

Nevertheless, both the Tax Court and the Court of Appeals concluded that the payment must be clothed with the tax attributes of an easement because that was the legal interest, or right, pursuant to which the original pipeline was constructed and maintained, and because the release of the easement and the pipe removal were viewed as part of the same transaction.

We do not contend that the pipeline relocation and the granting and releasing of easements were entirely independent transactions. We do contend that the relation between the easement release and the pipeline removal should not preclude deduction of the cost of the pipeline removal where it is clearly authorized by the applicable Code section. The cost of the pipeline removal was clearly attributable only to the activity of relocation. Adequate consideration—the grant of the new easement, for which petitioner claimed no deduction—was present to support the release to petitioner of the original easement.

The parties here intended that an easement be exchanged for an easement, and that money be paid for the activity of removing a pipeline. Whether one element would have occurred without the other begs the question. If either exchange was "ancillary" to the other, the negotiations of the parties (Exhibits 6 and 7) as well as economic reality indicate that the easement exchange was of the lesser significance.

This Court has established that "the tax law deals in economic realities, not legal abstractions," *Commissioner* v. *Southwest Exploration Co.*, 350 U. S. 308, 315 (1956), and that the incidences of taxation depend upon the substance rather than the form of a transaction. *Commissioner* v. *Court Holding Co.*, 324 U. S. 331 (1945).

It has also been stated that "[W]here part of a transaction calls for one tax treatment and another for a different kind, allocation is demanded." *Commis-*

sioner v. *Ferrer,* 304 F. 2d 125, 135 (2nd Cir. 1964), citing *Helvering* v. *Taylor,* 293 U. S. 507 (1935).

For example, where the sale of a business occurs, it is well established that allocation by the parties of the total consideration between goodwill, a capital item, and a covenant not to compete, an income item, will be respected for tax purposes if the allocation is supported by economic reality. *Ullman* v. *Commissioner,* 264 F. 2d 305 (2nd Cir. 1959); *Barran* v. *Commissioner,* 334 F. 2d 58 (5th Cir. 1964). The standard applied is whether genuine business reasons sustain the allocation. *Schulz* v. *Commissioner,* 294 F. 2d 52 (9th Cir. 1961).

Except for the sale-of-business situation, however, there is a need for further guidance from this Court as to the tax separability of transactions which encompass both deductible and non-deductible expense elements.

We respectfully submit that the hearing of this case will afford this Court the opportunity to promulgate clarifying standards for the separability of transactions in respect of deductible and non-deductible expenses which would facilitate the resolution at administrative levels of many tax controversies where this general problem exists.

CONCLUSION

For the reasons stated above, it is respectfully prayed that a writ of certiorari be granted to review the judgment of the United States Court of Appeals for the Sixth Circuit.

Respectfully submitted,

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